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TORONTO - NOT TO BE RELEASED BEFORE WEDNESDAY A.M. MARCH 13, 1985

FREE TRADE

The largest flow that has ever taken place between two countries is the one now occurring across the Canada/United States border...

'U.S. trade with the province of Ontario alone exceeds its trade with its next largest trading partner - Japan. Indeed, the United States carries on a surprising amount of trade with the province of Ontario alone. If Ontario were defined as a separate country then, as of 1983, it would be the largest market in the world for U.S. merchandise exports, larger than second-place Japan, with the rest of Canada in third place. Moreover, this U.S. export sale to Ontario would be larger than that existing between any other two countries at any time in history.'

This quote emphasizing the importance to Canada of trade with the U.S. comes from a special research report prepared for the Ontario Economic Council. The report Canada/United States Free Trade: Problems and Opportunities was written by Professor Ronald J. Wonnacott of the University of Western Ontario, and it takes a close look at the benefits and costs of free trade between the two countries.

This report reflects the views of the author and not necessarily those of the Ontario Economic Council. The Council establishes policy questions to be investigated and commissions research projects, but it does not influence the conclusions or recommendations of authors. The decision to sponsor publication of this study was based on its competence and relevance to public policy and was made with the advice of anonymous referees expert in the area.

The effects of remaining trade barriers

'With the elimination of trade barriers between the two countries, Canadian producers would rationalize - that is, they would specialize in a smaller range of goods, producing each good at higher volume and frequently at lower cost. In doing so, Canadian producers would be responding to both a carrot and a stick. The carrot would be free access to the large U.S. market. The stick would be the removal of the Canadian tariff, which would leave many Canadian firms unable to compete with less expensive imports unless they did rationalize and thus reduce their costs. The reductions in Canadian costs (that is, the increases in productivity) would eventually allow Canadian producers to increase their wages, reduce their prices, or both. (Indeed, inexpensive imports would force them to reduce their prices.) Thus, because of a combination of lower prices and increased wages, Canadian real income would rise. Estimates of these and other Canadian income gains that would result from bilateral removal of Canada/U.S. tariffs are very large - in the range of 5 to 10 per cent of Canadian GNP.'

Securing Canadian access to U.S. markets

Apart from the benefits free trade would bring, a major argument for it is to secure our present access to U.S. markets in a period when the U.S. may become increasingly protectionist. The report says our present level of exports to the United States is threatened by a build-up of protectionist pressures in the United States. While these pressures always exist, they have recently become stronger because of the large U.S. budget deficit and the associated strength of the American dollar:

'By keeping U.S. interest rates higher than they would otherwise be, this deficit has drawn a large flow of capital into the United States. This capital flow in turn has raised the value of the U.S. dollar and made it exceedingly difficult for U.S. firms to compete against imports. In these circumstances, it has been hard for the U.S. administration to resist appeals for relief in the form of protection from imports. As we

look to the future, it is not clear how long President Reagan will be able to resist protectionist pressure from Congress, especially as his second term starts to run out. Nor is it certain, in the longer view, that the next U.S. president will even be philosophically committed to freer trade'.

Canadian vulnerability

A Canada/U.S. free trade area would be a much more irreversible option for Canada than for the United States. But this study says it is important to keep this problem in perspective. It is not new; it is the traditional Canadian problem of dependence on the U.S. that would, in a sense, be made worse.

'It is a problem that would arise because under a free trade agreement our already high degree of dependence on the U.S. market would increase. But is there much chance that the United States would terminate such an agreement? Such an action seems very unlikely, because the United States could be severely hurt by the Canadian response. For example, the Canadian government might impose a large across-the-board increase in the tax on U.S. investment in Canada.'

Professor Wonnacott says no matter what we do we cannot guarantee against new U.S. trade restrictions: 'if (Canada) were to become adjusted to a free trade area, such restrictions would be much more costly for Canada. On the other hand, a free trade area would make such restrictions less likely - not only because the United States could not impose such restrictions against Canada without the drastic step of terminating the free trade treaty, but for another reason as well. A free trade treaty with the United States would provide Canada with an exemption from U.S. trade restrictions aimed at third countries (not only Europe and Japan, but also the rapidly industrializing countries of Southeast Asia, whose exports have been growing so rapidly).'

The study also points out that in the pact the United States has been ready to provide this kind of exemption for Canadian goods. To protect itself, Professor Wonnacott emphasizes that Canada should seek to 'embed such exemptions in cement', or get some guarantee that Canada will not be damaged by U.S. action against third countries.

A major fear of Canadians has always been that free trade with the U.S. would undermine Canadian independence. On this Professor Wonnacott says that free trade 'does not automatically launch the participants into an irreversible and irresistible escalation, with the eventual result of complete economic and political union. Indeed, no free trade area has ever led to political union. Economics is not the controlling force in the political sphere that it is often supposed to be.'

Adjustment problems

The study says that trade liberalization is like technological change: it tends to increase efficiency and overall income, but it involves adjustment costs as restructuring takes place, and employment falls in some industries and rises in others. Professor Wonnacott says there are two institutions already in existence which should help to reduce the short-run costs of adjustment to free trade with the United States. The first is our flexible exchange rate, which should provide some protection against a rapid influx of imports into Canada and a loss of employment here. Second, the presence of U.S. multinationals in Canada might also make the adjustment easier, since they would already have the facilities for distributing the newly specialized output of their Canadian plants throughout the United States.

He suggests there is need for a monitoring agency to handle disputes and appeals involving a free trade agreement. (A number of misunderstandings and complaints might have been reduced or avoided had such an agency been established for the Auto Pact.)

'Canada should seek an agency with equal representation from the two countries that would make binding decisions on matters of appeal - even though this arrangement, like any other binding international agreement, would involve some sacrifice of Canadian autonomy. The problem is that the United States would also be obliged to sacrifice some autonomy, so it is not clear that such a strong monitoring agency could be negotiated. A more realistic expectation might be the establishment of an agency that would make strong but non-binding recommendations to the two governments.'

Conclusions

Free trade with the U.S. would bring Canada substantial benefits: greater industrial efficiency, higher national income and higher wages, but to reap those benefits we would have to be prepared to face some short-term adjustments. It is this combination of short-term costs and longer-term benefits that has made Canadians defer a free trade policy from one generation to the next - with each generation perhaps regretting that the move was not made by its predecessor.

'But the longer we defer, the more we will miss opportunities to 'get in on the ground floor' in the exciting new industries that are now being born. In many such industries (though not all) delay involves serious costs: the longer we wait and the more established the industry becomes, the greater the difficulties we shall encounter in trying to break into it'.

And to keep the adjustment problem in perspective, we should also note that we are incurring more and more adjustment costs simply to maintain the status quo.

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Canada/United States Free Trade: Problems and Opportunities 30 pages, price $2.00, is available at the following outlets:

The Ontario Government Bookstore, 880 Bay Street, Toronto, to those shopping in person. Out-of-town customers may write: Publications Section, Fifth Floor, 880 Bay Street, Toronto, Ontario, M7A 1N8, or telephone 965-6015 (toll-free long distance, 1-800-268-7540; in north-western Ontario, 0-Zenith 6-7200). A cheque or money order, payable to the Treasurer of Ontario, must accompany all mail orders.

Renouf Publishing Company Ltd., 61 Sparks Street, Ottawa, Ontario K1P 5A6, telephone (613) 238-8985.

The Bookstore, Windsor Public Library, 850 Ouellette Avenue, Windsor, Ontario, N9A 4M9, telephone (519) 255-6765.